

**TESTIMONY TO THE
SUBCOMMITTEE ON WATER RESOURCES
AND ENVIRONMENT
OF THE COMMITTEE ON TRANSPORTATION
AND INFRASTRUCTURE
OF THE U.S. HOUSE OF REPRESENTATIVES**

REGARDING

WATER INFRASTRUCTURE FINANCING

**By
Eric S. Petersen, Partner
Hawkins Delafield & Wood LLP
One Chase Manhattan Plaza
New York, New York 10005**

February 28, 2012

Chairman Gibbs, Ranking Member Bishop, and Members of the Subcommittee:

It is an honor to be here today to offer the perspective of a municipal contract and finance attorney on our country's water infrastructure financing challenges.

My name is Eric Petersen and I am a partner at Hawkins Delafield & Wood, a leading national law firm in the fields of public finance, public contracts and public private partnerships. I specialize in water projects and represent the interests of municipal water utilities. Hawkins has negotiated major water infrastructure-related contracts for Seattle, San Diego, Phoenix, Santa Fe, San Antonio, Washington, DC, New York City, and more than 75 other cities, counties and authorities over the past 20 years. We were also centrally involved in the creation of six state revolving funds for water projects. Every year Hawkins typically issues formal legal opinions as to the tax-exemption of interest on more than \$15 billion in municipal bonds. We are

regular participants in major water industry forums, including the U.S. Conference of Mayors, the American Water Works Association, the Design-Build Institute of America, and the National Council of Public Private Partnerships.

The water business in the United States, in the broadest sense, is sound and stable. Low interest rate, tax-exempt financing is provided by a mature municipal bond industry, and projects are built by a deep market of highly skilled and experienced engineering and construction firms. Most water and wastewater systems are run by municipal managers, with the exception of investor owned water utilities and about 1000 plants where operations are outsourced to highly qualified contract operators. The industry has a solid record of compliance with the Safe Drinking Water Act and Clean Water Act, both passed more than 30 years ago.

A large vise, however, is causing relentless financial pressure on the water industry, forcing it to constantly re-think how it does business. On one side, there remains a fundamental unwillingness to raise user rates for obvious reasons. On the other, the unavoidable capital needs of a heavily capital intensive industry mount inexorably. Those needs arise from long-deferred capital maintenance; the necessity to replace obsolete assets and build new facilities; and ever-tightening state and federal regulatory standards, particularly in the nitrogen removal, combined sewer overflow, and treated water quality areas.

Federal financial support for water infrastructure consists almost exclusively of the tax-exemption of interest on municipal bonds issued for water and wastewater projects. The national grant programs have long since expired, and the federally-assisted state revolving fund programs of subsidized loans to municipal utilities are severely underfunded and, in many states, fall far short of the need. Proposals continue to surface in Congress and from the Administration to raise revenue by curtailing, by any number of means, the

tax-exemption of interest on municipal bonds. Passage of any of these measures would only serve to tighten the financial vise on the water industry.

Municipal water bonds are tax-exempt only if they are issued by the municipality itself, so called “governmental bonds.” Bonds issued for water projects by private companies — known as “private activity bonds” — are not tax-exempt, and thus carry the higher interest rates of corporate bonds. As a result, if a city wants to have a private firm design, build, finance and operate a new project (known as a “public private partnership”, or “P3” project) through a competitive process, the private financing element causes the debt to be taxable and generally makes the overall project costs too expensive. This is true even though the P3 water project serves the general public in exactly the way a municipally-financed project serves the public, and likewise remains owned by the municipality.

The Internal Revenue Code does contain an exception to the provision that makes private activity bonds taxable. Water projects are part of a category of private activity bonds called “exempt facility bonds.” The total amount of exempt facility private activity bonds that can be issued in each state is capped under legislation first passed 25 years ago, and currently aggregates about \$240 billion nationally. This is known as the “private activity bond volume cap.” Municipally issued private activity housing bonds traditionally have been, by far, the largest recipient of state volume cap allocations, essentially crowding out private activity bonds for water projects.

Private financing of public water infrastructure has thus been effectively blocked. The planning process for large water projects takes years, and the unlikelihood and uncertainty as to the availability of tax-exempt private activity bond volume cap for a proposed water project, as a practical matter, eliminates private financing and P3 approaches to project implementation from meaningful consideration when project delivery methods are considered by local municipal officials.

Completely removing the private activity bond volume cap applicable to water and wastewater projects may well help to moderate the water rate financial squeeze. P3 projects privately financed using tax exempt bonds generate substantial savings by virtue of the following:

- Expedited delivery schedules
- Guaranteed performance
- Early price certainty
- Guaranteed, lower costs
- Increased innovation
- Greater competition
- Qualifications based, best value contractor selection
- Full collaboration between the designer, builder and operator
- Transfer of design and construction risks
- Improved capital maintenance
- Single point of accountability
- Life-cycle focus
- Enhanced security for performance

Significant savings result as well in design-build and design-build-operate project procurements financed with traditional municipal bonds, and for the same reasons. And DB and DBO procurements are being successfully undertaken with increasing frequency in the water sector. Adding “financing” to the group of privately provided services has the potential, however, to deliver

even greater value to municipalities in select circumstances. These include particularly:

- Projects characterized by innovation, such as desalinization projects, biosolids management facilities, or treatment projects involving new technologies.
- Projects in which there is a higher degree of perceived performance risk, where the use of risk-taking equity capital may be appropriate.
- Situations where the municipality wants to turn over system management to a private concessionaire in order to get out of the business, receive a concession fee, improve service or reduce cost.
- Situations where the municipality does not want to issue debt or own the asset.

In each case, having the assurance that all present and future capital improvements can be financed on a tax-exempt basis would remove the only major hurdle to serious evaluation of the P3 approach to providing public water services. As others on the panel can testify, budget scoring studies have shown a negligible revenue loss to the Treasury from such a change.

Unrestricted tax-exempt private financing of public water infrastructure is no cure-all. Most projects surely will continue to be municipally financed using traditional water revenue bonds. But I am convinced that certainty as to the availability of tax-exemption for privately financed water projects could create a significant level of renewed interest from the private sector in providing new, innovative and flexible solutions to a wide variety of municipal water project challenges. The question is not “how are municipalities going to finance all of their water infrastructure needs.” They

can, with appropriate rate increases. The question is, “will assured tax exemption for private financing of water infrastructure assist in alleviating the rate squeeze?” The answer, for many projects, will be “yes,” by placing P3 projects and traditional projects on a level financing playing field and allowing the power of innovative, competitive contracting and financing to deliver best value.

This was indeed the case in 1986, when the certainty of tax-exempt private activity bond financing for municipal solid waste projects, which was provided by the Tax Reform Act of 1986, unleashed a burst of additional investment in waste-to-energy facilities and other privately financed projects needed in the solid waste management field totaling over \$15 billion.

To conclude with a real and current example in the water sector, the San Diego County Water Authority this year is going to contract for the purchase of water from an \$800 million seawater desalinization project in Carlsbad. It is a public-private partnership with Poseidon Resources, which will design, build, finance and operate the plant. Poseidon’s private financing makes the project bonds private activity bonds, but the company has secured a volume cap allocation from the State. This is an unusual and fortunate occurrence, made possible only by the collapse in demand for private activity housing bonds in the present market. The price of water, with tax-exempt interest rates, is projected at approximately \$1,850 per acre foot. With taxable financing, at interest rates about 100-150 basis points higher, the price would be over \$2,000 per acre foot, or around a 10% increase. It is quite possible that this key water resource project for California would not proceed had lower cost tax-exempt financing not been secured. The value of the assured tax-exemption thus is quite plain.

Thank you again for this opportunity. Water infrastructure financing needs, which are local by their nature, are often overshadowed by other, broader infrastructure issues, and we in the water industry applaud the

Subcommittee's renewed focus on the question today. I look forward to your questions and comments.